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April 17, 2009

AGENDA ITEM 4

TO: MEMBERS OF THE INVESTMENT POLICY SUBCOMMITTEE

I. SUBJECT: Adoption of Policy on Leverage

II. PROGRAM: Total Fund

III. RECOMMENDATION: Recommend to the Investment Committee adoption of the Statement of Investment Policy on Leverage

IV. ANALYSIS:

Background

As discussed with the Policy Subcommittee in February, the proposed Total Fund policy on leverage is intended to set forth a framework for comprehensively and effectively identifying, measuring, managing, and reporting various forms of leverage. A Fund-wide policy on leverage is also intended to result in greater consistency across investment units, and in greater ability of the Investment Committee to direct policies concerning leverage.

The proposed Policy and Wilshire's opinion letter are included as Attachments 1 and 2 respectively.

Proposed Policy

Key aspects from the proposed Leverage Policy are as follows:

A. The use of financial leverage magnifies investment returns both positively and negatively and could increase the volatility of returns. Market illiquidity increases the risk of a leveraged investment particularly under crisis scenarios. Leverage increases the risk exposure of asset classes and programs beyond the actual allocations. Hence leverage needs to be managed prudently and with limits.

B. For the purpose of this Policy, leverage is defined as "the use of debt, derivative instruments, cash collateral or other means to acquire more assets than the capital allocation." This definition includes asset-based debt (non-recourse, recourse) and notional leverage created by derivative strategies.

C. The Policy provides a framework for identifying, measuring and managing various forms of leverage that currently exist or could potentially exist and provides broad guidelines.

D. The Policy will require that the Asset Allocation and Risk Management Unit provide a quarterly report to the Investment Committee on leverage at the Total Fund level.

E. The Policy makes a distinction between non-recourse debt and recourse debt and recommends that the use of recourse debt requires approval in policy within limits. From an allocation and risk management point of view, recourse debt creates a contingent call on CalPERS capital and should ideally require a cash reserve.

F. Limits on the use of non-recourse debt shall be specified in the policies for programs that may employ asset-based direct debt (Private Real Estate, Infrastructure, and Forestland).

G. Global Equity (public equity) and AIM (private equity) are required to address management of leverage as a risk factor through their policies.

H. Consistent with existing policy, derivative transactions may not be employed to create leverage unless expressly permitted in the program policy.

I. The proposed Policy identifies leverage created through the use of derivatives or leverage created by using cash collateral to gain non-cash-like exposure as notional leverage that must have limits in the relevant program policy. Examples of such notional leverage include:

1) Portable alpha or enhanced equity strategy that gains equity exposure through futures and then invests the cash collateral in non-cash-like securities thus acquiring credit, duration, and other risk in addition to the allocated equity exposure; and,

2) Reinvestment of cash collateral from lending securities in non-cash-like securities thus acquiring credit, duration, and other risk exposure in addition to the exposure in the securities being lent.

J. The proposed Policy also identifies the "Credit Enhancement Program" as a source of contingent claim that requires an appropriate limit and possibly a cash reserve.

V. STRATEGIC PLAN:

This item supports Goal VIII to manage the risks and volatility of assets and liabilities to ensure sufficient funds are available, first to pay benefits and, second to minimize and stabilize contributions.

VI. RESULTS/COSTS:

There are no costs associated with this item.

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